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AMERICAN INDIAN LAW MEETS THE INTERNAL REVENUE CODE: *WARBUS V. COMMISSIONER*

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The relationship of the Internal Revenue Code to American Indians is not a hot topic in the academy for obvious reasons. Most Indian law scholars, like most scholars generally, avoid federal tax issues like the plague,[1] and very few tax scholars dip into the American Indian law literature.[2]

That is unfortunate. Federal tax law and American Indian law can intersect in fascinating ways. A recent Tax Court decision, *Warbus v. Commissioner*,[3] is unlikely to attract scrutiny in the practitioner journals since it involves the interpretation of a specialized Code provision, Section 7873, that few practitioners will ever come across. But it presents issues ranging from the mundane to the marvelous,[4] and it raises important questions about the judicial system's difficulty in handling cases, even those that are factually simple, if the disputes implicate more than one legal specialty.[5]

Relying on Section 7873, which provides an exemption for income from "fishing rights-related activit[ies],"[6] Warbus, a member of the Lummi Nation, did not pay tax on discharge of indebtedness (DOI) income arising from the foreclosure of his fishing boat. His position was plausible, and it deserved serious consideration. Nevertheless, Special Trial Judge John F. Dean rejected it in a strikingly cursory opinion, an opinion adopted by the Tax Court.[7] The American Indian law flavor of the case was apparent since Section 7873 has no effect outside the Indian law context. But Judge Dean's opinion is bereft of references to basic American Indian law doctrine, including the so-called "canons of construction" that often play a controlling role in this area.[8]

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1. The phrase "tax issues like the plague" is not supposed to suggest that the plague is a tax issue, although the plague might have estate-planning implications. My point is that American Indian law professors spend very little time on federal tax issues although *state* power to tax within Indian country comes up all the time in the typical introductory course.

2. One notable exception is Ellen P. Aprill, *Tribal Bonds: Indian Sovereignty and the Tax Legislative Process*, 46 ADMIN. L. REV. 333 (1994). *See* Erik M. Jensen, *American Indian Tribes and 401(k) Plans*, 68 TAX NOTES 117 (1995).

3. 110 T.C. 279 (1998).

4. *See generally, Id.* at 281-82.

5. The tax law/Indian law nexus is unusual, but everyone is familiar with fights about whether a case is grounded in tort or in contract.

6. I.R.C. § 7873 (1994).

7. The jurisdiction of Special Trial Judges is set out in Internal Revenue Code Section 7443A(b) and Tax Court Rules 180 through 188.

8. *See infra* Part II A.

If *Warbus* were a throwaway case, it would deserve little notice. But it is not. *Warbus* is a published opinion of the Tax Court, and it is intended to have precedential effect.[9] Since Section 7873 has not been the subject of prior judicial decisions, *Warbus* could have enormous effect in developing the understanding of that section.[10] Even more important, *Warbus* could come to stand for the proposition that the Tax Court can ignore American Indian law principles in tax disputes that involve Indian tribes or Indian tribal members.

I will show why none of that should happen. *Warbus* deserves to be discarded as precedent for at least two reasons. First, as I have noted, the opinion shows no awareness of fundamental American Indian law principles. Second, the decision is flawed even in its narrow, more technical aspects. In particular, the court did an inadequate job on the issues that should have been evident to any tax lawyer reading Section 7873. In fact, I will show how the judge misread the statute.

I emphasize that my criticisms of *Warbus* are based on professional concerns about the opinion and what it could mean for the development of the law. I am afraid that at times I may seem unfair to Judge Dean. Many of the problems in the opinion were not his fault. Judge Dean received little or no guidance from the litigants on some critical points, especially the basics of American Indian law. But regardless of where the fault lies, strong criticism is necessary to demonstrate why *Warbus* should be disregarded in later disputes arising from the intersection of American Indian law and federal tax law.

I. *WARBUS V. COMMISSIONER:* THE FACTS AND THE CODE

Around 1984, Warbus, a member of the Lummi Nation, bought a fishing boat, the Denise W, a purchase financed partly through borrowing from a commercial lender and partly by Warbus's note issued to the

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9. There is a neverending dispute within the Tax Court about the precedential effect of the court's not-officially-published "memorandum opinions," which "are supposed to be limited to those having no value as precedent [(i.e.,] any case decided solely upon the authority of another, cases involving subjects already well covered by opinions appearing in the bound volumes of the reports, failure of proof cases and some others." J. Edgar Murdock, *What Has the Tax Court of the United States Been Doing?*, 31 A.B.A. J. 297, 299 (1945); *see* Mark F. Sommer & Anne D. Waters, *Tax Court Memorandum Opinions—What Are They Worth?*, 80 TAX NOTES 384 (1998); *see also* RICHARD A. POSNER, THE FEDERAL COURTS: CHALLENGES AND REFORM 163 n.9 (1996) (collecting commentary). Whatever the value of memorandum opinions, however, a published opinion like *Warbus* is unquestionably precedent.

10. The only published authority on Section 7873 before *Warbus* was Notice 89-34, 1989-1 C.B. 674, which set out the government's position on some matters that are not directly relevant to this article. In *Kieffer v. Commissioner*, No. 9404-96, 1998 WL 281900 (T.C. June 6, 1998), decided shortly after *Warbus*, Judge Dean had occasion to cite Section 7873 once again, concluding inter alia—in what must be the least controversial ruling of the year—that income from timber sales is not income from a "fishing rights-related activity."

boat's former owner.[11] In 1984, Warbus borrowed another $50,000 from the commercial lender, a loan secured by the Denise W.[12] The proceeds were used, among other things, to acquire a salmon net, to make a payment on the earlier loan, and to make insurance and mortgage payments.[13] The Bureau of Indian Affairs guaranteed the $50,000 loan.[14]

From 1986 until 1991, Warbus was engaged in tribal fishing activity protected by the Treaty of Point Elliott,[15] and Warbus used the Denise W in that activity.[16] However, around 1993, Warbus defaulted on the $50,000 loan.[17] The boat was repossessed, and in 1993 BIA had to fulfill its obligation as guarantor, paying over $13,506, partly principal and partly interest, to the lender.[18] The BIA sent Warbus the appropriate form (a "1099") to indicate that he had $13,506 in DOI income.[19]

Warbus did not report the DOI income. In fact, he did not file a tax return or pay estimated taxes for 1993.[20] Since Warbus conceded that he had had rental income of $6,000 and self-employment income of $3,700 in that year, and he therefore unquestionably owed some tax, Warbus was not the most sympathetic litigant.[21] Nevertheless, although the fisherman's hands were not very clean, the proper tax treatment of the DOI income was a legitimate issue on its own.

Under traditional tax analysis, Warbus had taxable income from the discharge of indebtedness. He had borrowed money tax-free, and later he was relieved of the obligation to repay some of the borrowed dollars. That is the classic scenario for DOI income: you do not have to report the dollars when received because you are obligated to pay them back. However, if you are later released from the payback obligation, you then

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11. Warbus v. Commissioner, 110 T.C. 279, 280 (1998).
12. *Id.*
13. *Id.* at 280-81.
14. *Id.* at 281.
15. The treaty was signed in 1855 by the United States and a number of tribes, including the Lummi Nation, in the Washington Territory, and was ratified by the Senate in 1859. Treaty Between the United States and the Dwámish, Suquámish, and Other Allied and Subordinate Tribes of Indians in Washington Territory, 12 Stat. 927 (1859). Article V provides:

> The right of taking fish at usual and accustomed grounds and stations is further secured to said Indians in common with all citizens of the Territory, and of erecting temporary houses for the purpose of curing, together with the privilege of hunting and gathering roots and berries on open and unclaimed lands. Provided, however, that they shall not take shell-fish from any beds staked or cultivated by citizens.

Id. at 928.
16. *Warbus*, 110 T.C. at 281.
17. *Id.*
18. *Id.*
19. *Id.*
20. *Id.*
21. Trial Memorandum for Respondent, Warbus v. Commissioner, 110 T.C. 279 (No. 2194-96).

have income. In effect, DOI income represents a deferred inclusion of previously untaxed loan proceeds.

There may have been a discharge of indebtedness, or something substantively similar,[22] but Warbus could point to a special Internal Revenue Code section that arguably applied to his situation. Section 7873, added to the Code in 1988, provides in pertinent part that "no tax shall be imposed . . . on income derived . . . by a member of an Indian tribe directly or through a qualified Indian entity . . . from a fishing rights-related activity of such tribe."[23]

That is my case, argued Warbus. And the government conceded that, between 1986 and 1991, Warbus was engaged in a "fishing rights-related activity," which is "any activity directly related to harvesting, processing, or transporting fish harvested in the exercise of a recognized fishing right of [an Indian] tribe or to selling such fish but only if substantially all of such harvesting was performed by members of such tribe."[24] In general, "recognized fishing rights" means "fishing rights secured . . . by a treaty between [the] tribe and the United States or by an Executive order or an Act of Congress."[25] Those are exactly the sort of rights reserved to the Lummi Nation by the Treaty of Point Elliott.[26]

Therefore, for Section 7873 to exempt income from taxation in a case like *Warbus,* (1) a fishing rights-related activity must be in operation, and (2) the income at issue must be "derived directly from" that activity.[27] The protected activity was conceded to exist in *Warbus.* If the DOI income was sufficiently connected to the treaty-protected fishing activity, Warbus should have prevailed.

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22. Not everyone would characterize what happened in *Warbus* as generating DOI income. The lender was paid by BIA; it did not forgive Warbus's obligation. Nevertheless, I will use the term "DOI" in this article for two reasons. First, the parties and the court used the term. Second, the transaction can be re-conceptualized as DOI because BIA stepped into the lender's shoes, Warbus effectively came to owe BIA the $13,506, an obligation that was then forgiven. In any event, however one labels the theory for inclusion, there was unquestionably income to Warbus under traditional notions when BIA satisfied Warbus's obligation.

23. I.R.C. § 7873(a)(1) (1994).

24. I.R.C. § 7873(b)(1).

25. I.R.C. § 7873(b)(2).

26. *See supra* note 10.

27. The full text of Section 7873(a)(1) refers to "income derived directly *or through a qualified Indian entity.*" A "qualified Indian entity" is generally an entity that is formed by a tribe to engage in a qualified fishing activity and that meets certain specific, technical requirements—e.g., that "all of the equity interests in the entity are owned by qualified Indian tribes, members of such tribes, or their spouses." I.R.C. § 7873(b)(3)(A)(ii). Judge Dean concluded that the Bureau of Indian Affairs is not such a qualified entity and that this alternative route to exemption was therefore not available to Warbus. I do not dispute that part of the opinion.

II. HOW THE *WARBUS* COURT ERRED

The issue in *Warbus,* simply stated, was this: Was the DOI income of Warbus "income derived . . . directly . . . from" an activity that was conceded to be "a fishing rights-related activity" of the Lummi Nation? When I first saw squibs describing *Warbus,* my response to this question was Why not? Warbus used the Denise W in a tribal activity that the government agreed was a fishing rights-related activity, and the DOI arose from the foreclosure of that boat. After studying the issue, my response—now, I hope, a bit more thoughtful—is still Why not?

As I understand Judge Dean's opinion, he had two basic problems with Warbus's arguments: First, there was no express exemption of the DOI income from taxation and, second, the income was not closely enough connected with the treaty-protected activity. In a moment I will show why each of these is a non-problem. First, to set the stage, I will briefly describe the so-called "canons of construction" in American Indian law, canons that should have informed Judge Dean's opinion. If Warbus's arguments had any merit at all, the canons should have made his position a sure winner.

A. CANONS OF CONSTRUCTION

American Indian law is full of ambiguity: ancient treaties and statutes do not speak in modern terms. This problem is not a new one since the relationship of treaty and statutory language to everyday usage has always been tenuous at best.[28] Long ago, judges developed a set of principles, the so-called "canons of construction," to deal with the inherent ambiguity in this field.

The canons originated in treaty interpretation. Treaties with the Indian tribes have often been likened to contracts of adhesion, the powerful United States imposing its will on the relatively weak and powerless tribes. Everything, including the language used in the "negotiations" and final document, favored the United States at the expense of the tribes. To implement those treaties in a fair and reasonable way, judges must try to understand what the affected tribal officials thought they were agreeing to, or would have thought if they had been able to imagine the nature of twentieth century controversies, regardless of the

28. *See generally* Charles F. Wilkinson & John M. Volkman, *Judicial Review of Indian Treaty Abrogation: "As Long as Water Flows or Grass Grows Upon the Earth"—How Long a Time is That?,* 63 CAL. L. REV. 601 (1975).

actual treaty language used. As Chief Justice John Marshall made the point in *Worcester v. Georgia*:[29]

> The language used in treaties with the Indians should never be construed to their prejudice. If words be made use of, which are susceptible of a more extended meaning than their plain import, as connected with the tenor of the treaty, they should be considered as used only in the latter sense.[30]

More recently, the Court has concluded that "[d]oubtful expressions are to be resolved in favor of the weak and defenseless people who are the wards of the nation, dependent upon its protection and good faith."[31]

That principle has remained the law. The canons are phrased in different ways in different cases, but the basic tenets remain: Try to understand provisions as the unlettered Indians would have understood them; if there is doubt, resolve the doubt in favor of the tribes; and so on. In general, whatever the language used, the canons encompass the following points: "1) very liberal construction to determine whether Indian rights exist; and 2) very strict construction to determine whether Indian rights are to be abridged or abrogated."[32]

Chief Justice Marshall was writing about interpreting treaties in *Worcester,* but the canons have been extended since his day to apply to the interpretation of statutes, executive orders, and regulations as well. This is not a matter of choice: Judges are obligated to follow the canons. Accordingly, if there is doubt about the language in legal authority affecting Indian rights, that doubt must be resolved in a way favorable to the affected tribe or the affected tribal member. It would not be overstating matters much to say that, in disputes arising from the interpretation of treaties, statutes, and other documents, if a court sees ambiguity in the relevant language, the position of the tribe or the tribal member will prevail.[33]

In fact, the canons ought to apply in determining whether there is an ambiguity needing resolution.[34] It is entirely consistent with the canons as they have developed to require courts to look for ways to interpret

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29. 31 U.S. (6 Pet.) 515 (1832).

30. Worcester v. Georgia, 31 U.S. (6 Pet.) 515, 582 (1832).

31. Carpenter v. Shaw, 280 U.S. 363, 367 (1930).

32. DAVID H. GETCHES ET AL., FEDERAL INDIAN LAW: CASES AND MATERIALS 348 (3d ed. 1993).

33. Tribal interests and the interests of individual tribal members may not coincide in particular cases. For present purposes, I put that real problem to the side; no such conflict existed in *Warbus.*

34. Similar debates occur in connection with "plain meaning" theories of statutory interpretation. How much ambiguity is necessary before a court may look at something other than the statutory language? How plain must a "plain meaning" be? Of course, critics of plain-meaning doctrines suggest that judicial adherents of the doctrine see plain meaning only when doing so leads to the desired interpretation. *See* William D. Popkin, *Law-Making Responsibility and Statutory Interpretation*, 68 IND. L.J. 865, 875-80 (1993).

controlling language in favor of the affected tribe or tribal member. Put another way: If there is a question about whether ambiguity exists, the canons point toward finding an ambiguity, one that must then be resolved favorably to Indian interests.

The application of the canons may not always be clear, and judges have circumvented the canons by purporting to find no ambiguity in inherently ambiguous documents. However, even when that happens, judges typically acknowledge the existence of the canons and explain why the canons do not affect the result.[35] The canons, after all, are part of the law. To altogether ignore the canons, and to make no attempt to honor their commands, is unacceptable in a late twentieth century American Indian law case.

But that is what happened in *Warbus*. There is no particular reason to expect a Tax Court judge to be aware of the canons. Judges need help in understanding areas of the law with which they are unfamiliar, but Judge Dean was left to his own devices. Other than citing cases in which the canons had been discussed,[36] the parties gave Judge Dean no hint of the canons' existence.[37] The fault was not the judge's, but his innocence does not make *Warbus* any more palatable as authority.

B. THE PRESUMPTION OF TAXABILITY AND ITS RELATIONSHIP TO AMERICAN INDIANS

With the American Indian law canons of construction as a backdrop, I now examine Judge Dean's problems with Warbus's argument. It is not the case, noted Judge Dean, that a Native American's income is presumed to be exempt from federal taxation. Quite the contrary. The judge wrote, "Tax exemptions, including those affecting native peoples, are not granted by implication. If Congress intends to exempt certain income, it must do so expressly."[38]

That tax exemptions cannot be granted by implication is a generally unobjectionable proposition, and American Indians are federal taxpayers, except in special situations.[39] But it is not clear what that proposition

35. *See*, e.g., County of Yakima v. Confederated Tribes and Bands of the Yakima Indian Nation, 502 U.S. 251, 263 (1992) (applying canons generously to forbid excise tax on sale of fee land within reservation boundaries while generally downplaying effect of canons in concluding that *ad valorem* tax on such lands was permissible).

36. Squire v. Capoeman, 351 U.S. 1 (1956); *see infra* notes 41-53 and accompanying text.

37. Indeed, Warbus's Reply Brief credited the Commissioner with having "recite[d] an unexceptional history of the intersection of Indian Law with Tax Law," even though there had been no mention of the canons in the government's brief. Petitioner's Reply Brief at 2-3, Warbus v. Commissioner, 110 T.C. 279 (1998) (No. 2194-96). There was no recitation of the canons, even in boilerplate form, in any brief. *See generally id.*

38. *Warbus*, 110 T.C. at 282-83.

39. For example, a treaty might protect members of a particular tribe from having to pay other

has to do with the *Warbus* facts. The claim was not that Warbus's income was automatically outside the reach of the Code. A claim of that nature would have been a sure loser.[40] The claim was that Section 7873 is the express exemption that Congress has the power to grant. Facing a plausible argument that a specific, express exemption existed, Judge Dean should have parsed the statutory language carefully to see whether Section 7873 applied to Warbus. Had he also been better advised about his obligations in an American Indian law case, he should have examined the statutory language with the canons of construction in mind.

That is what the Supreme Court did in the 1956 case *Squire v. Capoeman,*[41] which dealt with the tax liability of an Indian couple. The Capoemans claimed exemption from federal income taxation on the proceeds of timber sold from their allotted lands. They had not yet been issued a patent in fee simple for those lands.[42]

Simply put, the government's primary position in *Squire* was that, as American citizens, the Capoemans were subject to federal income taxation. As the Court explained, "The government urges us to view this case as an ordinary tax case without regard to the treaty, relevant statutes, congressional policy concerning Indians, or the guardian-ward relationship between the United States and these particular Indians."[43] While it is true, wrote Chief Justice Warren, that "in ordinary affairs of life, not governed by treaties or remedial legislation, [Indians] are subject to the

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wise applicable federal taxes, or a statute like Section 7873 of the Code could exempt all of a tribal member's income.

40. *Warbus*, 110 T.C. at 282-83. In fact, in three cases decided before the enactment of Section 7873, the Tax Court had ruled that income from treaty-protected fishing activities was taxable. *See* Estate of Peterson v. Commissioner, 90 T.C. 249, 252 (1988); Earl v. Commissioner, 78 T.C. 1014, 1020 (1982); Strom v. Commissioner, 6 T.C. 621, 628 (1946), *aff'd per curiam*, 158 F.2d 520 (9th Cir. 1947). Congress sidestepped the status of pre-Section 7873 fishing income: "Nothing in the amendments [establishing Section 7873] shall create any inference as to the existence or non-existence or scope of any exemption from tax for income derived from fishing rights secured as of March 17, 1988 . . . ." Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 3044(b), 102 Stat. 3342, 3642. I am not sure those cases were correctly decided, but that does not matter for this analysis. To say that Warbus's income might have been taxable had there been no 1988 tax legislation is not to say it should have been taxable with Section 7873 on the books.

41. 351 U.S. 1 (1956).

42. *Id.* at 3. This is not the place for an extended discussion of allotment. It is enough for present purposes to understand the following: Congress in the late nineteenth century enacted a number of allotment laws, which were intended to break up the Indian land mass and convert the American Indians into yeoman farmers. When applicable, the acts "allotted" 80 or 160 acre parcels to individual Indians. The parcels were to stay in trust until the passage of a certain period of time or until the Indian became "competent," i.e., was deemed fit to become a citizen, at which time the individual was to be issued a patent for the land by the federal government. In most cases, the land passed out of Indian hands altogether; the allotment acts were disastrous for American Indians as a whole. But in many particular cases the trust period was extended. Since 1934 no patents have been issued for allotted lands; lands held in trust at that time have continued to be held in trust. The Capoemans held land that had been allotted to Mr. Capoeman, and they therefore had a special tie to that land. However, they did not have, and would never have, fee simple title. *Id.* at 4.

43. *Id.* at 5-6.

payment of income taxes as are other citizens,"[44] *Squire v. Capoeman* was no ordinary tax case.

The Capoemans' situation was not ordinary because there were statutory provisions, relating to allotted lands, that arguably exempted their timber income. Therefore, the Court examined provisions of the General Allotment Act of 1887[45] and a 1906 amendment to that Act,[46] enactments that defined the nature of the Capoemans' interest in the lands from which the timber had been taken. The General Allotment Act could be interpreted as precluding all taxation of allotted land until a patent had been issued. It was only after the issuance of a patent that "all restrictions as to sale, incumbrance, or *taxation of said land* shall be removed."[47] This language suggested to the Court "a congressional intent to subject an Indian allottee to all taxes only after a patent in fee is issued to the allottee."[48]

Indeed, said the Court, if there was any doubt about how the General Allotment Act should be read in these circumstances, the canons of construction removed that doubt. With the "doubtful expressions" of the Act read favorably to the Capoemans,[49] no federal tax could be imposed on income from the allotted land. Moreover, relying on writings of Indian law scholar Felix Cohen, the Court interpreted the exemption to apply to "income derived directly" from the land,[50] a category that included the net proceeds from the timber sales.

Like Judge Dean in *Warbus,* the *Squire* Court accepted the general proposition that "exemptions to tax laws should be clearly expressed."[51] But that proposition merely begins the analysis. In an Indian law context, individuals searching for "express" exemptions must do their research mindful of the canons of construction.[52] The

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44. *Id.* at 6.

45. Ch. 119, 24 Stat. 388 (codified as amended in scattered sections of 25 U.S.C.).

46. Act of May 8, 1906, ch. 2348, 34 Stat. 182 (codified at 25 U.S.C. § 349).

47. 25 U.S.C. § 349 (1994) (emphasis added). In its nearly full form, the proviso to Section 6 of the General Allotment Act, as amended, reads as follows:

> That the Secretary of the Interior may, in his discretion, and he is authorized, whenever he shall be satisfied that any Indian allottee is competent and capable of managing his or her affairs at any time to cause to be issued to such allottee a patent in fee simple, and thereafter all restrictions as to sale, incumbrance, or taxation of said land shall be removed . . . .

Id.

48. *Squire*, 351 U.S. at 7.

49. *See* Carpenter v. Shaw, 280 U.S. 363, 367 (1930).

50. *Squire*, 351 U.S. at 9 (quoting FELIX S. COHEN, HANDBOOK OF FEDERAL INDIAN LAW 265 (1942)).

51. *Id.* at 6.

52. The effects of the canons can be tempered in some special situations. For example, once Congress acts to clearly make land subject to state taxation, reacquisition of the land by a tribe will not exempt the land from taxation. Congress must make any new exemption "unmistakably clear." Cass County v. Leech Lake Band of Chippewa Indians, 118 S. Ct. 1904, 1910 (1998).

Supreme Court in *Squire* analyzed the controlling statutes in a way favorable to the Indian taxpayers to see whether an "express" exemption existed; that's what Warbus should have asked the Tax Court to do in *Warbus*.[53] Instead, he punted.[54]

All of which brings us to the interpretation of Section 7873, the claimed express exemption in *Warbus*. I will argue that the canons of construction were not necessary to find an "express" exemption for Warbus's DOI income, since Section 7873 is clear enough on its own terms. However, whether that argument is right or not, the canons should have made this an easy case for the taxpayer.

C. SECTION 7873: THE CONNECTION BETWEEN INCOME AND "ACTIVITY"

Section 7873 lends itself to good old-fashioned statutory analysis of a sort that tax lawyers do every day.

1. The Structure of Section 7873

Warbus, Judge Dean wrote, "argue[d] that the purchase of the *Denise W* and expenditures for associated equipment and operating expenses are fishing-rights related and that therefore the income from discharge of indebtedness incurred to meet these expenses is fishing-rights related."[55] What precisely is the problem with that argument?

Since the government had conceded that a "fishing rights-related activity" existed, the problem had to be that Warbus's DOI income was insufficiently connected with that activity. In Judge Dean's words, the DOI income was the "result of the freeing of [Warbus's] assets from obligations by the BIA in 1993, not from any *activity* by him 'directly related' to harvesting, processing, transporting, or selling fish in the exercise of recognized fishing rights of an Indian tribe."[56] This is the passage that I would like to focus on in the *Warbus* opinion.

To begin with, Judge Dean garbled the statutory language. Compare the *Warbus* quotation, with its reference to "*activity* by him" and

53. *Squire*, 351 U.S. at 6-8. Particularly when the canons of construction are applied, the usual requirement that an exemption from taxation be "express" should not be interpreted to mean "beyond any doubt." That someone can come up with a different spin on statutory language should not mean, by itself, that a provision is not "express."

54. *See* Petitioner's Reply Brief at 2-3, Warbus v. Commissioner, 110 T.C. 279 (1998) (No. 2194-96) ("Petitioner Warbus agrees that, absent some expressed exemption found in statute or treaty, Indians are subject to the federal income tax laws the same as any other citizens.").

55. *Warbus*, 110 T.C. at 282.

56. *Id.* at 283 (note omitted).

the quotation marks around "directly related,"[57] with the actual language of Section 7873.[58] The statute does not include the words "by him."[59] As I discuss below, Judge Dean improperly personalized the "activity" requirement. Moreover, the "directly related" phrase that Judge Dean highlighted is merely part of the definition of "fishing rights-related activity," and that definition was not at issue in *Warbus*. Because the government had conceded that a qualifying activity existed, the only question should have been whether the income at issue was "derived . . . directly . . . from" the qualifying activity. None of the language in the quoted passage addresses that portion of Section 7873.

Suppose Warbus had been able to show that he purchased the boat, paid expenses, and therefore incurred the associated debt only for the purpose of engaging in the Lummi Nation's treaty-protected activity. If he could have shown that—a position which the government largely conceded[60]—surely that would have been enough of a connection to make the DOI income tax-exempt.

Or would it? If I am reading the passage from Judge Dean's opinion correctly, one of his concerns was the relative passivity of the DOI income; for all we know, Warbus may have been asleep at the precise moment the DOI income was realized. I interpret Judge Dean's phrase "from any *activity* by him" as drawing this activity versus passivity distinction. It does not matter, that is, why the Denise W was acquired and how it was used; it does not matter why the borrowing occurred. If so, *Warbus* would mean that DOI income can never be Section 7873 income.

If that is what he meant, Judge Dean misunderstood the word "activity" in Section 7873. Return to the statutory language: "income derived . . . directly . . . from a fishing rights-related activity."[61] The "activity" required by the statute is the "fishing rights-related activity," which includes "harvesting, processing, or transporting fish harvested in the exercise of a recognized fishing right."[62] The statutory language is

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57. *See supra* text and accompanying note 56.

58. *See supra* notes 23-25 and accompanying text.

59. In another part of the opinion, Judge Dean used language almost identical to the language quoted above, but without the nonstatutory phrase "by him." *See Warbus*, 110 T.C. at 283.

60. *See* Respondent's Brief in Answer at 12-13, Warbus v.Commissioner, 110 T.C. 279 (1998) (No. 2194-96) (citations omitted):

> It is not disputed in this case that Petitioner obtained the $50,000 loan, which the BIA satisfied in 1993, primarily to obtain funds for use in Petitioner's treaty fishing rights-related activity. It is not disputed that the Denise W, the asset which secured this $50,000 loan, was utilized in Petitioner's treaty fishing rights-related activity. Further, it is not disputed that Petitioner was engaged in a treaty fishing rights-related activity from 1986 to 1991, the time during which the Denise W was operated by petitioner.

61. I.R.C. § 7873(a)(1).

62. I.R.C. § 7873(b)(1).

as clear as it can be that the required "activity" is the overall structure of treaty-protected behavior that a tribe engages in and from which tribal members derive income: "from a fishing rights-related activity of such tribe."[63] The requirement that there be such an activity was satisfied in *Warbus*; the government had conceded the point for the Lummi Nation.

In the passage quoted above, Judge Dean would instead have us ask whether the income was "from any *activity* by [Warbus] . . . 'directly related' to a [treaty-protected activity]." That is too much activity for me,[64] and it is more activity than Section 7873 requires. By mixing up the "activity" requirement and the "income derived directly" requirement of Section 7873, Judge Dean effectively rewrote the statutory provision. Section 7873 focuses on the connection of the income with the protected activity, not on whether the particular taxpayer is doing physical activity at the time an item of income is earned or an expenditure is made.

2. *The Meaning of "Activity" in Other Code Sections*

Judge Dean's conception of the term "activity" does not fit Section 7873, and it is not supported by the way the term is used elsewhere in the Code.[65] To make that point, I will discuss the oxymoronic passive activity loss (PAL) rules of Section 469, enacted in 1986, only two years before the passage of Section 7873, and the at-risk rules of Section 465, enacted in 1976 but significantly extended in 1986.[66] These two Code sections were the primary, and largely successful, weapons used against abusive tax shelters.

I am going to try, as simply as possible, to show that use of the term "activity" in an Internal Revenue Code provision does not necessarily mean that a taxpayer must be engaged in vigorous exercise to be subject to the statute. Indeed, the PAL rules would make no sense with such a requirement. To have an interest in a passive activity, and therefore to be subject to Section 469, requires that a taxpayer not be personally

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63. I.R.C. § 7873(a)(1).

64. I agree with the statement usually attributed, probably erroneously, to Robert Maynard Hutchins: "Every time I think about exercise, I lie down until the thought passes."

65. Judge Dean made no reference to the term's use elsewhere. This failure (and it is a failure) was not entirely his fault. As with the canons of construction, he received no help from the parties. On the other hand, interpreting Code language is part of his job.

66. Whatever the empirical validity of the assumption that members of Congress have any knowledge of the language used in other Code provisions, that assumption is made all the time by courts. *See, e.g.*, Goodyear Atomic Corp. v. Miller, 486 U.S. 174, 184-85 (1988) ("We generally presume that Congress is knowledgeable about existing law pertinent to the legislation it enacts."). This is an assumption that seems particularly appropriate when a term, like "activity," was used in 1988 legislation, only two years after it was a centerpiece of the widely noted PAL rules.

active.[67] The at-risk rules also were intended to attack certain loss-generating investments, denominated "activities," in which investors were likely to be personally inactive.

a. Passive Activity Loss (PAL) Rules

Suppose a taxpayer-doctor has a loss attributable to his interest as limited partner in a limited partnership that engages in a trade or business. There is, by definition, activity going on, but the taxpayer does not participate very much, if at all, in the activity. That is the quintessential interest in a passive activity, a trade or business in which the taxpayer does not materially participate,[68] and that is the sort of loss-generating investment Section 469 addresses.

Section 469 made losses from passive "activities" much less valuable than they had been under pre-Tax Reform Act of 1986 law, in that such losses can be used only to offset income from passive activities.[69] The doctor cannot use his PALs to currently offset his active income from medical practice, nor can he use the passive losses to offset his portfolio income, the dividends, interest, and so on he earns from his investments.[70] He can carry the currently unusable losses forward to use when he has generated additional passive activity income[71] but, all other things being equal, deferred losses are not as valuable as currently usable ones. By limiting the utility of PALs, Section 469 made investments in loss-generating passive activities much less attractive than had been the case before 1986.[72]

Now suppose our hypothetical limited partnership recognizes some DOI income associated with the trade or business it conducts. The doctor's limited partnership interest remains an interest in a passive activity.

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67. Of course, taxpayers generally do not want to be subject to Section 469: those with losses do not want the losses limited by the PAL rules. But a taxpayer with PALs that would otherwise not be currently deductible wants income to be characterized as coming from a passive activity.

68. I.R.C. § 469(c)(1) (1994). Material participation is defined in Section 469(h)(1). Interests in limited partnerships are presumptively interests in passive activities. I.R.C. § 469(h)(2).

69. Section 469(a)(1) disallows the deduction of a "passive activity loss," which is defined as the excess of losses from passive activities over income from passive activities. I.R.C. § 469(d)(1). The effect is that losses from passive activities may be deducted currently to offset any income from passive activities.

70. Section § 469(e)(1) defines such income as not being from a passive activity.

71. I.R.C. § 469(b). When a taxpayer disposes of substantially his entire interest in a passive activity in a fully taxable transaction, (e.g., by selling the limited partnership interest), he can then deduct the previously suspended losses. I.R.C. § 469(g)(1) (defining such losses as not from a passive activity).

72. As a result, doctors will not passively invest in such activities to generate losses to offset their medical income. Section 469 has been so effective because it has largely eliminated the objectionable behavior to which the provision would otherwise apply.

Can DOI income attributable to such a passive activity be income from a passive activity to our hypothetical limited partner? Absolutely, if the connection with the passive activity is shown.[73] That is, the income can be associated with an activity even though the taxpayer is completely inactive; that is the very nature of income from a passive activity.[74] And that is one of the lessons to transfer to the analysis of Section 7873.

DOI income is neither inherently active nor inherently passive; its character under Section 469 depends on the nature of the activity to which it is allocated. That characterization has almost nothing to do with the extent of the actual efforts involved in generating the DOI income. Under the PAL rules, the extent of a taxpayer's participation is significant in determining whether his interest is a passive activity—does he materially participate?—but the characterization of a particular item of income or loss is not determined by looking at the taxpayer's level of effort with respect to that item. It is simply, or sometimes not so simply, a matter of determining whether the income is attributable to the passive, or non-passive, activity.

b. At-Risk Rules

Another example of the use of "activity" can be found in the at-risk rules of Section 465, Congress' first attack on tax shelters. In general, Section 465 in general limits a taxpayer's ability to take deductions relating to an "activity" to the amount that the taxpayer has "at risk" in the activity.[75] As is true with the PAL rules, the at-risk rules make certain sorts of deductions much less valuable than used to be the case (in general, deductions attributable to nonrecourse debt and other risk-limiting arrangements used in almost all abusive tax shelters).[76] One does not avoid being subject to Section 465's limitations by arguing that one is inactive. In addition, income, including DOI income, can be

73. *See* Rev. Rul. 92-92, 1992-2 C.B. 103 (discussing allocation of DOI income between passive activity expenditures and other expenditures). The focus is allocation "at the time indebtedness is discharged." Characterization of income as passive would generally be a good thing for taxpayers who have otherwise nondeductible PALs. *See supra* note 67; *see also* Priv. Ltr. Rul. 95-22-008 (Feb. 22, 1995) (holding DOI income to be investment income on the facts).

74. Would DOI income attributable to an activity not be income from a passive activity if the taxpayer materially participates in the activity? Again the answer is Yes. DOI income can clearly be treated as income from a "trade or business," a term that presupposes the existence of activity. Section 108 of the Internal Revenue Code, which provides for special deferral rules for DOI income in special circumstances, assumes that DOI income can be associated with a trade or business.

75. I.R.C. § 465(a)(1) (1994). Taxpayers are generally at risk for the amount of cash and the adjusted basis of property contributed to the activity, and for the amount of borrowing for which they are personally liable. Taxpayers are not at risk for amounts borrowed on a non-recourse basis. *See* I.R.C. § 465(b), (c).

76. This is not to say that nonrecourse debt is necessarily abusive. It is to say that abusive shelters routinely used nonrecourse debt, or what purports to be nonrecourse debt.

attributable to an "activity" even though a particular taxpayer's efforts in the activity are minimal or nonexistent.

The relevant determination under the PAL and at-risk rules is whether the DOI income relates to an "activity." The question is not whether the particular taxpayer engaged in a certain level of activity with respect to that one income item. There is no apparent reason why the same analysis should not apply under Section 7873,

3. *Connection of DOI Income with the Lummi Nation "Activity"*

We know that there was a "fishing rights-related activity" in *Warbus*, since the government conceded that point. The appropriate question, the only question, should have been whether the DOI income was "derived . . . directly . . . from" that activity, not whether Warbus was "active" in generating the DOI income.

It would not strain the statutory language at all to see DOI income attributable to the foreclosure of a fishing boat acquired for use in a "fishing rights-related activity" as being "derived directly from" that activity, just as DOI income can be income from a passive activity. If that was Warbus's situation, and it is consistent with what we know of the facts,[77] he should have won. Such an interpretation of Section 7873 would not create serious opportunities for manipulation by members of treaty-protected tribes. The connection between the DOI income in *Warbus* and the protected activity was hardly imaginary.[78] And it would not create tax shelter opportunities that Wall Street could take advantage of.[79]

One should not interpret the "derived directly from" language in Section 7873, particularly when read with the canons of construction, as requiring an impossibly difficult showing of a connection between the

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77. *See supra* note 50.

78. The government emphasized that Section 7873 should not be used to confer "tax-free status on other income derived by Indians from other sources." Respondent's Brief in Answer at 12, Warbus v. Commissioner, 110 T.C. 279 (1998) (No. 2194-96) (quoting *Hearings on S. 1239 Before the Subcomm. on Taxation and Debt Management of the Senate Comm. of Finance*, 100th Cong. 13 (1988) (statement of Dennis E. Ross, Deputy Assistant Secretary of the Treasury for Tax Policy)). That principle is unobjectionable as a general matter, but it is hard to see how holding this DOI income exempt—income from foreclosure of a *fishing boat*—would create opportunities to exempt income from other sources.

79. At least I do not think it would, but one should never underestimate the creativity of tax planners: "The tax bar is the repository of the greatest ingenuity in America, and given the chance, those people will do you in." *Legislation Relating to Tax-Motivated Corporate Mergers and Acquisitions: Hearings Before the Subcomm. on Select Revenue Measures of the House Comm. on Ways and Means*, 97th Cong. 90 (1982) (testimony of Martin D. Ginsburg) (*quoted in* Jonathan L. Entin, *Privacy, Emotional Distress, and the Limits of Libel Law Reform*, 38 MERCER L. REV. 835, 835 (1987)).

income at issue and the protected activity. That was not the purpose behind the language. It was intended to require allocation between exempt income and non-exempt income—not all fishing income is necessarily exempt to a tribal member—not to impose unsuperable burdens of proof. The Senate Report on the Technical and Miscellaneous Revenue Act of 1988,[80] which included the new Section 7873, notes that the Act "exempts only that income 'derived' from fishing rights-related activities. Thus, . . . individual tribal members . . . are required under the bill to allocate income and expenses among fishing rights-related activities and all other activities."[81] Fair enough: the "directly derived" rule is an allocation rule, not a burden of proof provision. Life is made up of activities, and it is necessary to allocate income items, like DOI income, among those activities.[82] The report then contains an example of when allocation is required:

> If . . . an individual tribal member derives 60 percent of his or her gross income in a taxable year from fishing in protected waters and the remaining 40 percent from fishing outside protected waters, then 60 percent of the member's income would be exempt from tax . . . , and any expenses . . . attributable to such exempt income could not be used to offset gross income derived from fishing outside prohibited waters or any other income.[83]

If Warbus had used the Denise W in part for treaty-protected fishing, and in part for other purposes, then some of the DOI income should not have been exempt.

But except for one obscure footnote[84] in a Senate Finance Committee report, a footnote that is hardly controlling,[85] nothing in the statutory

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80. Pub. L. No. 100-647, 102 Stat. 3342 (codified at scattered sections of 26 U.S.C.).

81. S. REP. No. 100-445, at 475 (1988).

82. Which is to say that DOI income is attributable to some activity.

83. S. REP. No. 100-445, at 475.

84. To fans of footnotes, "obscure footnote" is not redundant.

85. The footnote stated that an entity should not fail the 90% test to be a "qualified Indian entity" in a particular year "solely by reason of extraordinary and nonrecurring events, such as the sale of a boat or other property." S. REP. No. 100-445, at 474 n.141. The 90% test provides, somewhat simplified, that a qualified Indian entity must derive 90% or more of its annual gross receipts "from fishing rights-related activities of one or more qualified Indian tribes." I.R.C. § 7873(b)(3)(A)(iii) (1994); *see also supra* note 27 (discussing qualified Indian entities). Treating boat sales specially was necessary, argued the government, because net sales proceeds were understood not to be "from fishing rights-related activities." Without the special rule, a boat sale could therefore have disqualified an otherwise qualified entity. If boat sales proceeds are not Section 7873 income, the government continued, neither is income attributable to a boat's foreclosure. Respondent's Brief in Answer at 12-13, Warbus v. Commissioner, 110 T.C. 279 (1998) (No. 2194-96). The government's argument has some force, but it gives much too much weight to what is, after all, a footnote in a report on a tangential issue. The purpose of the 90% test is to determine whether an entity is a qualified

language or the legislative history suggests that all $13,506 of DOI income should have been automatically taxable.

Perhaps there are weak spots in this analysis at some level; lawyers can pick holes in almost any argument. But with the canons of construction as reinforcements, I am confident that any manufactured doubts should have been resolved favorably to Warbus. The Supreme Court in *Squire v. Capoeman* interpreted similar "derived directly" language liberally (although, in that case, a phrase interpreting statutory language rather than a phrase taken from the controlling statute) to hold some of a tribal member's income exempt from federal income taxation.[86]

In Judge Dean's defense, there are facts in *Warbus* that could reasonably have given the court pause on the statutory interpretation issue. The borrowing occurred in 1984, a couple of years before Warbus participated in the fishing activity of the tribe. Perhaps that is a significant fact although, if so, one wishes that the judge would have explained its significance.[87] In addition, the DOI income was not recognized until 1993, a couple of years after Warbus had ceased participating in the activity. Perhaps that too is a relevant fact (although, again, one would like to know why).[88]

Indian entity; it has nothing to do with whether an individual's income is attributable to treaty activity. In addition, the footnote's purpose is to suggest that, consistent with the canons, the apparently all-or-nothing test to be a qualified Indian entity should not be applied in a draconian way. It would turn the canons on their head to use this passage to restrict exemption under Section 7873. Finally, for what it is worth, gain from the sale of an asset and DOI income are not the same thing. *Cf.* I.R.C. § 108(a) (1994) (permitting deferral of DOI income but not gain in some circumstances).

86. *See supra* note 50 and accompanying text.

87. Maybe he did so indirectly. Judge Dean noted that:

> even had petitioner's loan proceeds been income in the first instance in 1984 [i.e., the year of borrowing], their source was not activity directly related to harvesting, processing, transporting, or selling fish in the exercise of recognized fishing rights of an Indian tribe. Forgiveness of the repayment of those loan proceeds by a third party cannot convert the freeing of petitioner's assets into fishing-rights-related income merely because the loan proceeds were used to purchase equipment used in such an activity.

Warbus v. Commissioner, 110 T.C. 279, 284 (1998). Putting aside the judge's continued conflation of the "derived directly from" and the "activity" tests, I suppose that passage can be interpreted as attaching significance to the fact that the borrowing preceded Warbus's participation in the tribal fishing activity: that is, the borrowing, had it otherwise been taxable, would not have been protected by Section 7873 (which did not exist in 1984); a later discharge of the indebtedness therefore should not escape taxation. Even if that is what Judge Dean meant, he was not necessarily right. The DOI income must be analyzed under Section 7873. The income was not realized until 1993; since it was not "secured as of March 17, 1988," it was not governed by pre-1988 Act law. *See* Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 3044(b), 102 Stat. 3342, 3642 (codified at 26 U.S.C. § 7873 (1994)) (quoting language of 1988 Act, § 3044(b)).

88. Surely DOI income attributable to a taxpayer's passive activity would continue to be income from a passive activity even if it were recognized after the underlying trade or business ceased. *Cf.* I.R.C. § 469(f)(1) (1994) (permitting carried-over deductions from a former passive activity—e.g., because the taxpayer's level of participation has increased—to offset income from the no-longer-passive activity).

III. A FINAL CANON SHOT

As I read Section 7873, Warbus had good arguments in support of his position even without the canons of construction. If we apply the canons, as we are obligated to do, the result is an easy one: DOI income arising from the foreclosure of a boat used in a treaty-protected fishing activity is exempt.

A skeptical reader might suggest that the canons should not have been applied in *Warbus* because the Section 7873 issue was not a typical "Indian rights" question. It was a tribal member rather than the Lummi Nation who would have benefitted directly by a different result in the case. I am not persuaded.

Section 7873 deals with traditional, treaty-protected tribal rights; applying the statute in a narrow way to a tribal member inevitably affects the economic well-being of the tribe. And it is not as though the canons have been applied only in cases in which tribal rights have been directly implicated. As we have seen, the Supreme Court, in its most important case discussing the federal income tax liability of individual Indians, *Squire v. Capoeman*,[89] applied the canons as a matter of routine.[90]

In any event, as far as I can tell, *Warbus* was not the result of a principled determination that the canons were irrelevant. No such determination could have been made; the judge was not aware of the canons' existence. The failure to apply the canons may not have been Judge Dean's fault, but it was a failing. As a result, the opinion in *Warbus* is an inherently incomplete analysis. That fact by itself should give us pause in relying on the *Warbus* opinion in future cases.

IV. CONCLUSION

The world is not necessarily made up of purely American Indian law cases or purely tax cases. Sometimes apparently discrete bodies of law intersect, and courts, practitioners, and scholars must deal with that overlap. *Warbus* should have been such a case.

Unfortunately, counsel for Warbus merely noted the "intersection of Indian Law with Tax Law"[91] and then did little or nothing to help Judge Dean deal with that intersection. It would not have taken much.

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89. *See supra* notes 41-53 and accompanying text.

90. Although the tribal members lost in each case, the canons were nominally applied in the pre-Section 7873 cases considering the federal income taxation of income derived from treaty-protected fishing. *See supra* note 40.

91. Petitioner's Reply Brief at 3, Warbus v. Commissioner, 110 T.C. 279 (1998) (No. 2194-96).

A boilerplate recitation of the canons of construction would have helped alert the judge to the American Indian law implications of the case.

I am not sure why *Warbus* turned into such a disaster. Part of the problem, I suspect, is that it was not a big dollar case. The tax due on $13,506 of income, after taking into account the effects of standard deductions, personal exemptions, and low marginal rates, is very small. A case of this sort will therefore not elicit the legal effort that the larger issues might justify, and some of the technical issues would have taken substantial time to develop.

On the other hand, very little effort was necessary to get the American Indian law issues on the table. If nothing else, *Warbus* illustrates the dangers in having individual Indians litigating issues that affect larger, tribal interests. Section 7873 of the Code has important effects on tribal members who engage in protected fishing, but the ultimate beneficiaries are the tribes. Exempting members' income from federal income taxation promotes the economic position of tribes. Warbus's inadequate arguments led to an incredibly limited understanding of the income eligible for exemption, and it is tribal interests that will suffer if *Warbus* is taken seriously as precedent.

Obviously the *Warbus* opinion cannot be airbrushed out of the legal picture;[92] it is there in print (and on line) for us to ponder and criticize. But we should get as close as we possibly can to the effect of airbrushing: the next time a court hears a Section 7873 issue it should act as if *Warbus* had never been decided.

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92. *Cf.* DAVID KING, THE COMMISSAR VANISHES: THE FALSIFICATION OF PHOTOGRAPHS AND ART IN STALIN'S RUSSIA (1997).